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Panel discussion on "The impact of mergers of accounting firms on the auditing profession"

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Panel Discussion on "The Impact of Mergers of Accounting Firms on the Auditing Profession"

Editor's Note: The panel consisted of the following members:

Stephen J. Aldersley, Ernst & Young, Canada
David W. Hunerberg, Deloitte & Touche
Jonathon E. Killmer, Coopers & Lybrand
Julia A. Lelik, Peat Marwick Thorne, Canada
Roger R. Nelson, Ernst & Young
James K. Loebbecke, University of Utah

The practitioner's comments were based on their personal experience and philosophy along with the firm's experience and philosophy. The academic member of the panel, Professor James Loebbecke, concluded the discussion with his views on the subject. The comments are given below in the order they were presented.

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Stephen J. Aldersley
Ernst & Young, Canada

I would like to begin my comments with a short parable outlining some of the factors that led to the accounting firm mergers. Many of these were mentioned yesterday by Ed Kangas in his luncheon address.

The Parable of the Geese
(Or, What to do when your goose is cooked!)

Once upon a time there were eight large flocks of colored geese. We'll refer to each flock by its color: Red, Orange, Yellow, Green, Blue, Purple, White and Black. Geese from these flocks ate Kentucky Blue Grass, which was considered a delicacy amongst the geese species.

At the same time there lived a wide variety of hunters who grew grain to eat. Because they all believed that goose droppings were beneficial to their crops, the hunters always planted patches of Kentucky Blue near their crops so the geese would fly by. Occasionally, when there was a crop failure, there would be a local food shortage and the hunters would shoot the geese they had attracted with their Kentucky Blue.

Over time, each of the geese flocks developed relationships with smaller flocks of ducks who would take on the goose flock color, leading to big flocks of geese and ducks. Ducks, of course, couldn't eat Kentucky Blue, but they could eat almost anything else, or at least that's what they said. Hunters sometimes liked having ducks around because they would eat some of the weeds in the grain fields. Sometimes the ducks would get out of control and eat some of the grain. Since the hunters weren't that bright, they didn't always notice, but if they realized what the ducks were doing, they'd shoot them too. But this didn't happen very often.

One of the reasons the geese wanted to be with ducks is that a large combined flock around a patch of Kentucky Blue would keep other flocks away. The ducks liked the opportunities the geese provided and could usually scrounge some food even when there were no weeds. The only major difficulty they had was that sometimes ducks and geese would try to mate. Such attempts weren't always successful, and when they were, gucks were created. By the way, a guck doesn't know what its there for and he or she will oscillate between goose-like and duck-like behavior. This confused the hunters.

For the longest time the world seemed to be a nice place for the geese, the ducks and the hunters. There were the occasional little spats and a few geese and ducks were shot and eaten, but generally, things went along fairly smoothly. The different flocks got along pretty well, each one sticking to its patches of Kentucky Blue. Then things started to get complicated. Local hunters began to plant grain in other worlds and foreign hunters began to buy local fields. The big flocks began to grow and needed more Kentucky Blue. New rules of goose etiquette were proclaimed, making it harder for the geese to get at the Kentucky Blue. Hunters were given more powerful guns, Dingells for example. Hunters were also forming cooperatives and some were even going out of business.

The geese and their duck partners of course, were caught in the middle. All the colored flocks were making agreements with flocks in other worlds. They were also absorbing some of the lesser uncolored flocks. But the big problem they were all facing was that the hunters weren't prepared to plant as much Kentucky Blue to attract the geese. The geese, being birds, didn't help matters. One flock was always prepared to visit grain fields served by another flock for less grass. The overall result was that the growth in the amount of Kentucky Blue Grass was less than the desired growth in the size of the flocks, a real population crunch.

The solution, which came gradually, was to rationalize the flocks. The belief was that the largest flocks could muscle in on comparatively smaller flocks and grow through aggressive behavior by taking a larger portion of a smaller pie. First, the Red flock merged with a very large uncolored flock to become the Crimson flock. Then an attempt was made to merge the Blue flock with the Green flock, but they blew it when their affiliates in another world couldn't agree. Then came the big one. The Yellow flock merged with the White flock to become the Gingham flock. Very soon afterwards, the Green flock merged with the Black flock and the Blue flock tried to merge with the Orange flock. The last one didn't work nor were the others successful in all worlds. But the damage was done. Instead of eight colored flocks there were now only six.

It would be nice to be able to say that they all lived happily ever after, but unfortunately, it was not to be. Lord Caparo came along and said that hunters could not use bullets in their guns. It took a while for it to sink in, hunters are a little slow you see, but in the end they realized there was no point in giving the geese so much Kentucky Blue. If you couldn't shoot them, you couldn't eat them. They didn't taste very good anyway. Finally, the geese had to learn to eat weeds. So ends the parable of the geese.

What Does the Future Hold?

The parable deals with most of the factors that led to the mergers except perhaps for the competitive advantage that stronger industry specialization brings to the merged firms. The future still holds many challenges for the profession. The market for audit services will not grow faster than the economies of the countries in which the public accounting profession is well developed. (There are of course opportunities in Eastern Europe and in Asia, but the North American market is saturated.) In some cases it will not grow as fast. In the absence of mergers, all large firms (the Big Six) will grow at the same basic rate. There will be a period of trading, discounting etc., but in the end there will be relatively less for everyone in the business.

The middle market will gradually disappear as the mid-sized firms are caught in the squeeze between the large international firms and the small local practices. This has already begun in Canada with the complete or partial disintegration of Eisenberg, Collins Barrow, and Laventhol and Horwath. Firms which have only a regional or national scope will not be able to compete unless they find a niche.

Another critical challenge will be the relevance of the audit service itself. We need to respond to the Caparo[1] decision in the House of Lords in which the duty of care issue has been revisited. If this decision becomes an important precedent for other auditor litigation, there may be less exposure to liability but it would also challenge the utility of our services.

The expectation gap will continue to haunt the profession. The substantial auditing standards activity in the US will not prevent the future occurrence of "audit failures". These events have always been relatively rare and will continue to occur for the same reason they've occurred in the past. There is a limit to what can be accomplished in an audit, something that has been acknowledged in professional standards but has not been well understood by the public. The mergers do little to benefit the profession in this area and in some cases make matters worse as clients, and the public, fail to perceive any benefits to them.

The increasingly complex environment is making it hard to attract new students into the profession. In Canada, the qualification process that is added on to a fairly hefty educational requirement is a major ordeal for the students. As a profession, we are not always getting the best and brightest of the available graduates and it is now extremely difficult to attract students with non-accounting university education. This will certainly challenge our ability to grow our business in the future.

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[1]See *World Accounting Report,* May 1990.

Audit Approach in a Merger Environment

An interesting issue in a major merger situation is the audit approach that is adopted by the merged firm. It may surprise some that this issue is not a major factor in merger discussions. One would think that the process used for the primary business activity would be of considerable importance to the merger participants. But this doesn't seem to be the case. If all else is agreeable, then disagreements over methodology will not stop the merger. A compromise will be made.

Once merged, however, the audit methodology becomes a critical issue. When you throw staff from each predecessor firm into the same office so they work on the same clients, the daily work process is perhaps the most important issue. Given this motivation, there is tremendous pressure to quickly develop a merged audit methodology.

In many respects, the claims of the merged firms that their combined audit approaches are or will be superior to the approaches each used previously may well be valid. Since all big eight firms' audit approaches resulted in a high level of quality, one would expect that the effect of combining two approaches would not undermine their effectiveness. In practice what happens is the combined approach is developed by adopting what are perceived to be the strong points in each of the predecessor approaches. In what I've seen, the more extreme aspects of the predecessor methodologies have been eliminated in the merged approach, leading to a more efficient overall process.

Despite this efficiency improvement, there will remain aspects of the combined approach which are inefficient if only because adopting a more efficient method would introduce something neither predecessor firm was familiar with. Such situations can arise during the analysis of the predecessor approaches when opportunities to adopt more efficient approaches than either of the predecessors are identified. Implementation practicality issues also need to be considered. Everyone in the merged firm will need to learn something new but if the combined approach uses features similar to at least one of the predecessors, half the staff will be familiar with any one aspect of the approach. Something entirely new would affect everyone with no one having previous experience. The objective is efficiency and effectiveness of the entire process including the human factors. So the result of the combining process is not perfect, but in my view, it is surprisingly good given the time pressure involved.

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David W. Hunerberg

Deloitte & Touche

Introduction

Good afternoon. I am David Hunerberg from the Kansas City office of Deloitte & Touche. As are my fellow panel members, I am here to present my perspectives of the impact of mergers of accounting firms on the auditing profession.

Before I present my views, I believe it's important for you to understand the perspective from which I am speaking. As you all know, Deloitte & Touche is currently experiencing, first hand, the results and the impacts of a merger from both a professional and business standpoint. I have been actively involved in the merger activities from my position as Office Managing Partner of the former Touche Ross Kansas City office, a position I have held since 1983. I am currently serving as the Office Managing Partner in the new firm, Deloitte & Touche, for the Kansas City office. I was a member of the Board of Directors of Touche Ross & Co. and, accordingly, was actively involved in many of the discussions and considerations which arose as a result of the merger. In addition, I currently serve as a Group Managing Partner for nine Deloitte & Touche offices in the central and the southwest portion of the country. And, I am a member of the Deloitte & Touche Management Committee. As a member, I actively participate in many of the management decisions and the development of policies and practices that are being established as we form our new firm. So, that's a little background on my perspective.

Base Line Assumptions

As we talk about the impact of mergers on the auditing profession, I think it's also important to comment briefly on why we have mergers in the profession. I believe that the mergers have been driven by both inside and outside demands and pressures. The outside pressures tend to focus around one key element – *client service.* Clients are continuing to demand, as they always have, a high level of professional quality service from their auditing firm. Clients should, as they always have, expect that much from an auditing professional. These expectations, however, have continued to change over the past several years as our clients have broadened their perspective and we looked (and found) additional ways to serve them. Our economy has become a global marketplace in which there are strong economic business centers in North America, Europe and the Pacific rim. As an example, more and more of our clients are finding themselves operating in this global environment and no longer focusing on merely local or regional economic developments, even in Kansas. This is true not only of the larger clients of any office, but is perhaps surprisingly true for many of the smaller clients of any office that find themselves purchasing from foreign vendors and even acquiring foreign subsidiaries or opening purchasing offices or distribution centers overseas. Because of these pressures, the profession is changing in reaction to the worldwide global marketplace perspective gained by our clients. To be effective, a professional auditing firm must have a strong presence in these significant global marketplaces – North America, Europe and the Pacific rim. The inside reasons are a lot about economics, leverage and profitability. Clearly, the very large firms understand and tout the benefits of their size. We see it in the efforts they put into research, contributions and in recruiting, as just three examples.

Impact of Mergers on the Professional

The number one asset of any professional firm is its *people*. The continued development and growth of these resources is critical to the survival of any professional firm and is essential to insure continued quality service. I believe mergers of accounting firms will have a positive impact on research, education and technical developments. But the mergers will also provide opportunities to the individual professional in terms of his or her personal and professional growth. As firms become larger and broader in perspective, individuals within those firms will have more opportunities to specialize in various industries or to develop and refine expertise in various technical areas. With the expansion of the client base and the combination of human resources created by the mergers, the individual professional is better able to focus his or her efforts and development in his or her own area of interest and expertise. As an example, in Kansas City, the professionals who previously served ten different clients in five or six different industries will now be able to concentrate their skills in one or two different industries – enabling them to grow professionally at a faster rate and deliver a higher level of client service to our customers. Mergers will have the same impact on the technical resource professionals who are typically based at national offices of the firms. These professionals are able to regroup and refocus on more specialized lines or functional responsibilities as the national offices of merged firms are brought together.

Our primary practice focus has not been changed by the merger. The audit partner continues to be responsible for insuring that the audit services meet the client expectations and firm and professional standards. The merger will better equip the partner to fulfill his responsibilities by providing increased and more specialized resources.

As I mentioned earlier, the exterior reason to merge is to provide quality client service. That has always been a very high priority for any professional services firm. Client service should be driven by the needs of the client. The realities of today's economy such as the increasing importance of business in Japan, the unification of Europe, free trade with Canada and the emergence of Eastern Europe are fairly obvious changes in our current economic reality and require a change in our focus and an increased emphasis in our service delivery capabilities.

Consulting

All the major firms have become consulting firms. Each firm reports that 50-60 percent of their revenues come from auditing but only two-thirds of that amount come from "standard auditing". That may mean that only approximately 40 percent of the business is the standard recurring audit. Clients hire consultants for their ability to identify and help solve problems in specific areas of their business. They want to know, most likely, if you have ever done this specific job before. We have vast networks to identify these experts throughout the firm and now have more of them.

The nature of the "standard audit" has changed, too. Companies continue to look for advice outside of the opinion area. In proposal situations, a winning proposal often is one that contains substantive consulting comments about operations or tax planning ideas.

This consultive focus is not an impact of mergers, but the audit professional will find himself better prepared to face the challenge as a result of the larger firm networks and improved resources created by the mergers.

Impact on Audit Practice and Technical Developments

The mergers of accounting firms are creating opportunities to refine, streamline and modernize the audit process. As firms combine, audit methodologies will be developed that will draw from the best of the merged firms. In fact, at Deloitte & Touche we are currently in the process of introducing a new audit approach that will take the best of the two predecessor firms. In fact, when asked whether the new audit approach most resembles the Deloitte approach or the Touche approach, the head of the audit methodology task force said the new D&T audit approach would be drawn 75 percent from the Deloitte approach and 75 percent from the Touche approach. We hope that this is an instance where the sum of the two parts taken together will result in a process that is well beyond where either firm had been in the past.

In today's business environment having the best audit approach is no longer enough. It must be supported by powerful and flexible mainframe and microcomputer software. Today's audit professionals will have at their command an impressive array of computer-assisted audit systems and tools. We have a development center located in Princeton, New Jersey dedicated to keeping us on the leading edge of technology. With our clients' information processing systems becoming more complex, we need specialists, at the direction of the audit engagement team, to evaluate the controls within that environment.

The development of new auditing processes and technological advancements are not unique results of the mergers of accounting firms. All firms, in the past, have revised and updated their audit process almost continually in order to remain competitive and to react to changes in the environment and the economy. These refinements, however, have typically been slow and have taken a great deal of time to develop, implement and refine. Competitive pressures brought upon other firms through the creation of these new audit processes will force other auditing firms to critically evaluate and perhaps revise their audit techniques sooner than they may have without the impact of the mergers.

Support for Education and Research

I also hope that mergers of accounting firms will create opportunities for improvements in research, education and technical developments. As the national offices of the merged firms are combined, the result is clearly a sum greater than the total of the two parts. The combination of pools of technical resource people enables these people to focus on specialized accounting areas, the development of top quality educational programs and continued research on accounting and auditing issues. By reallocating the use of human resources within the combined national offices of the merged firms, the firms are able to either examine new and different topics and issues or double their efforts in the completion of current projects that were underway prior to the merger. Although there will certainly be some elimination of duplicate positions and responsibilities, the mergers also provide the opportunity to make use of the best resources available in all instances.

I don't believe that the mergers of firms will result in a reduced level of academic support. I hope Deloitte & Touche will expand the existing programs of support and activity.

Conclusion

I have discussed but a few of the impacts of mergers on the auditing profession. As you can imagine, within a merged firm the impacts, consequences and challenges are great and there are many issues that need to be dealt with both on a national and a local level. However, our emphasis has not changed. Our number one focus is to provide quality professional service to our clients. As a result, we believe that our clients are the big winners as a result of the mergers of firms. Our clients have benefited from an improved, more effective and efficient auditing process, better trained and well-rounded auditing professionals and the receipt of services from an enhanced, worldwide organization that is balanced and strong in the world's major economic regions.

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Jonathon E. Killmer
Coopers & Lybrand

Today I speak to you on the subject of mergers in the accounting profession from the viewpoint of a firm that has not participated in the "mega-merger binge". Coopers & Lybrand has not found it necessary nor advantageous to enter into a merger with another large firm.

To appropriately analyze the impact of a merger, or, in the case of Coopers & Lybrand, no merger, one must have an understanding of the reasons why a firm would seek to strengthen its position by undertaking what has been termed a "mega-merger".

Four areas surface when one explores why a firm would merge. These are:

- Better service to global clients
- Technology
- Capital
- Economics

Of course, on the other side of the formula for mergers, there are inherent risks. These can be categorized as follows:

- Significant dislocation and change
- Diversion of focus from the marketplace to tasks involved in internal integration
- Possible diversion from client service because of change
- Uncertainty in the minds of partners and staff

Clearly, Coopers & Lybrand is not opposed to mergers, but we do not believe in merging just for a merger's sake. In fact, we have been the beneficiary of recent mergers, particularly in the European market, which has positioned Coopers & Lybrand as a pre-eminent firm as we approach 1992. However, we at Coopers & Lybrand value our culture and recognize it as a significant competitive strength.

Let me share with you a series of events that took place in 1989 and 1990 that were the result of "inappropriate cultural fits", which in turn significantly enhanced Coopers & Lybrand.

In February, 1989, the Swedish representative of KPMG merged with Coopers & Lybrand.

In April, 1989, Treuarbeit, German representative of Price Waterhouse, merged with Coopers & Lybrand.

In October, 1989, Deloitte in the United Kingdom announced its intention to merge with Coopers & Lybrand, rather than joining in the Touche merger.

In October, 1989, Deloitte in the Channel Islands announced it would merge with Coopers & Lybrand.

In October, 1989, Deloitte Belgium merged with Coopers & Lybrand.

In November, 1989, Deloitte Austria merged with Coopers & Lybrand.

In January, 1990, Touche Ross Spain merged with Coopers & Lybrand.

I bring these mergers up to point out why the cultural fit is so critical. We strongly believe that a strong cultural fit is of paramount importance. Basically, culture includes the personalities of the firms, the way they are organized, and their objectives, philosophy and priorities. This is particularly true in an professional services firm, where teamwork is the foundation of a successful organization. When the fit isn't right, dysfunction results and ultimately secession occurs.

Therefore, a primary consideration at Coopers & Lybrand for considering any merger is that we are not willing to give up our culture and, in essence, become a different firm. Those firms which embody the same cultural traits as Coopers & Lybrand become ideal merger candidates. Such traits include quality service, commitment to attracting and retaining outstanding people, an environment that is open, encouraging and driven by self determination, and an environment where initiative, innovation and creativity are encouraged.

Now, let us address some other points, including practice, technology, consulting and support for education and research.

As I previously stated, one of the reasons most often given for mergers is to provide better service to global clients, with mergers creating a better balance of global coverage for the firms involved. Fortunately, Coopers & Lybrand started on this voyage in 1957 with the creation of Coopers & Lybrand International – bringing together principally the U.S. firm of Lybrand Ross Bros. & Montgomery and Cooper Bros., a U.K. firm spanning the British Commonwealth.

Through the years, we have added countries and firms – and incidentally have never had a member firm secede – to where Coopers & Lybrand has, in place, the critical mass necessary to successfully compete in the global marketplace. Recent additions to our firm's roster of clients – such as Avon, Cadbury, Schweppes, Kraft, the Limited, Mutual of Omaha, Sanyo, and Unilever – attest to our worldwide competitiveness. Now, with the addition of the firms previously mentioned, we have significantly added to an already potent force.

Touching briefly on technology, Coopers & Lybrand has long been acknowledged as a leader in audit technology – developing, many years ago, a worldwide uniform audit approach. Coopers & Lybrand also established the first fully dedicated computer auditing group and first created expert system software such as ExperTax. We are currently developing a fully integrated microcomputer-based audit workstation.

At our Manufacturing Technology Center, clients can play out "what if" scenarios to determine the impact of advanced technologies, such as just-in-time or computer integrated manufacturing, before making a multimillion dollar investment.

We have more than sufficient capital to continue our investments in technology. In fact, our challenge is not in the availability of capital, but to make sure that we are investing in the right activities to stimulate our long-term growth.

Let us now focus on consulting. Our management consulting practice has long been recognized for focusing on emerging issues. Our recent study "Made in America: A Survey of Manufacturing's Future", has captured national attention with its findings on the competitive position of U.S. manufacturers. Our philosophy of "Solutions for Business" is a reflection of the consulting practice.

This philosophy means bringing value by helping to identify and assess the risks and opportunities formed in the shifting business landscape. This, of course, translates into quality service. We remain committed to strengthening and enhancing our global consulting network, along with our other services, through internal growth as well as merger and acquisition opportunities in specific markets.

This brings us to the issue of support for education and research. This has been and will continue to be a strength of our firm. In the area of higher education, a Coopers & Lybrand Foundation program, "Excellence in Audit Education", has reached over 25,000 students at 250 colleges and universities across the country. This program includes the widely acclaimed "Cable Co. Chronicles" videotape series.

The firm continues to fund significant developments in the whole education process, particularly curriculum development and teaching. We are also proud to support the cooperative effort of all six large firms, including Coopers & Lybrand, in funding the Accounting Education Change Commission – a truly extraordinary effort to improve accounting education.

Finally, we recently launched "Supporting Youth Education", a mobilization of our people in a national effort to keep students in high school and to improve the quality of education. For example, in my office in St. Louis, we have 35 volunteers, both professional and administrative, providing tutoring sessions and conducting role model classes in six middle schools in the inner city public schools.

In review of the four reasons for merging, let us look at each of the criteria as it relates to Coopers & Lybrand.

- Better client service to global clients – C&L already has the infrastructure in place.
- Technology – our firm is already on the leading edge and continues to demonstrate its creativity and innovativeness.
- Capital – as previously stated, we have sufficient capital – the key is directing its appropriate use.
- Economics – our present organization is functioning well and is appropriately focused on the marketplace

This basically states the reasons why Coopers & Lybrand chose not to enter into a merger. But of course, as previously stated, the most important issue is culture.

In summary, at Coopers & Lybrand, we have demonstrated we have the size, strategy, momentum and the will required to compete successfully in the global marketplace. But most importantly, we continue to achieve significant growth. For example, from 1982 to 1989, worldwide, Coopers & Lybrand revenues more than doubled. Our firm is well positioned domestically and internationally to meet the opportunities and challenges of our new environment. At Coopers & Lybrand, we face the future with confidence and a spirited commitment to the continued, well-managed growth of our firm.

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Julia A. Lelik
Peat Marwick Thorne

No one who practices in the auditing profession will have failed to notice that the landscape is changing. As the world realigns itself economically and politically, it is also growing smaller with the advent of technological achievements in communication and the continued growth and dominance of multinational corporations. The market place is more competitive and many businesses (some, the largest in the world) know no geographical boundaries.

Auditing firms are reacting to this global change by positioning themselves to better serve their clients as they expand their businesses into the larger and seemingly more fertile international marketplace. We have already seen one result – mergers either nationally or internationally, or both. Many of the panel members here today have experienced the magic and mystery of mergers. Auditing firms that a short time ago saw themselves as competitors, are now pooling their auditing, accounting, consulting, taxation and other resources.

Mergers mean bringing people, standards, methodologies, technologies and cultures together. This "bringing together" presents many challenges and opportunities which arise as the fabric of a new and larger auditing firm is woven. As a result the impact of mergers on the auditing profession can be addressed in a number of ways. I would like to limit my observations to my own recent experience in "merging" the auditing methodologies of the predecessor firms that now represent Peat Marwick Thorne, the Canadian firm of Klynveld Peat Marwick Goerdeler (KPMG).

Background

In September, 1989 Peat Marwick Thorne was formed through the merger of Thorne Ernst and Whinney and Peat Marwick. Thorne Ernst and Whinney was a member of the international firm of Ernst & Whinney (now Ernst & Young) and Peat Marwick was a member of KPMG. The international firm of KPMG itself was formed in 1987 through the merger of KMG (Klynveld Main Goerdeler) and PMI (Peat Marwick International).

Both Canadian predecessor firms were well established in the Canadian auditing scene with histories dating back to 1869 for Thorne Ernst and Whinney and 1913 in the case of Peat Marwick. Peat Marwick Thorne emerged as the largest auditing firm in Canada after the merger activity settled down.

Comparing Audit Approaches

When firms merge, a natural step is to compare the way things were done in the predecessor firms. Previously, as competitors, information as to how "the other firm" conducted its audits was, at best, sketchy. The merger afforded us an opportunity to consider and study in considerable detail "the other" methodology. In today's auditing environment it was not surprising to find our audit processes were supported by quantitative models and computer technology.

Much energy is devoted to studying and structuring auditing models to assist auditors in making consistent judgements. Nevertheless I have found that auditors tend to ask two very fundamental and practical questions:

What procedures need to be applied in the circumstances?
How much do I need to do?

While this may appear to be an obvious observation, these questions were at the root of many of the specific and more technical issues being considered as we were making our comparisons. In my view, the successful development of an audit process and its acceptance by its users depends not so much on its sophistication but rather on its ability to quickly and appropriately answer those simple questions on a basis consistent with their own intuitive judgement.

The Whole is not the Sum of its Parts

Another common question auditing firms ask is: are we doing more or less than our competition? A merger presents the opportunity to assess the validity of a perception that may have existed that one firm was doing more or less audit work than the other.

In making comparisons between audit processes, my experience suggests that each model must be considered as a complete package. If the model is dissected and comparisons made only on a component by component basis there is limited insight into the end product gained if the whole is not also considered. For example, how much to audit is traditionally determined by decisions as to the risk of error in the account and the auditor's required precision. If we only compared the risk levels being used in the models we might inappropriately conclude that one approach causes us to do more work than the other because the detection risk being assumed is lower than the other. On the other hand, we may reach a different conclusion if a comparison was made of both the precision and risks being used.

Do we stop there? Should we also measure and take into account the various hurdles each process sets to lower detection risk? For example, more onerous documentation or compliance testing standards to establish lower control risk in one approach may provide a greater barrier to increasing detection risk than under another. Does this then mean one approach will cause the auditor to do more, more often than the other?

Implications for the Auditing Profession

In the end, if one looks at the actual procedures selected and amount of work done under the different approaches they were remarkably similar. But an examination of the details of the processes suggests that different firms follow somewhat different pathways to answer those simple questions. If the end result is about the same, then a stringent policy in one component in a given process would need to be balanced by a less rigorous requirement in another. But between the two audit processes themselves the mix of the policy decisions made may be different. I once heard someone say that there are two pathways to the the truth – through science or faith. In auditing firms there seem to be many!

In a merger, the challenge lies in reconciling the differing pathways so that the auditors using the "merged" audit process see it as familiar, yielding results consistent with their own judgement. Expand this harmonization effort from a national level to the international arena and the complexity of the process is multiplied. But to better serve our clients internationally there is no other option.

In the larger context of standard setting for the profession one can only speculate. Imagine a body of auditors meeting to discuss one aspect of auditing with each deriving their view of the specific issue from their experience with their own audit process. Will the standard evolve as a stringent one or not? Would the standard have been different had all at the table known the pathway used by the others?

One cannot help but wonder what impact, if any, the combination of increased knowledge of the "competition's" audit process and fewer auditing firms on the playing field will have on the auditing standards the profession will set for itself in the future.

Some Closing Thoughts

In closing, I would just like to add that, while mergers bring with them problems, they also bring solutions. They bring with them not only challenges but also opportunities. They bring with them the jolt of sudden change but they can also spur progress on. They bring with them conflict but also harmony. They bring with them unknowns but also insight. Mergers mean coping with and managing change. But then is not one of life's constants change itself?

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Roger R. Nelson
Ernst & Young

Good Afternoon!

Why Merge

Professional services firms face significant challenges from the external environment in terms of *globalization, regulation, deregulation, privatization, specialization,* and rapid *technological change.* In addition, we must face the internal challenges of *client service, quality, productivity,* and *cost.* Succeeding in the professional services business depends on how we succeed with these challenges. It will not suffice simply to respond to them, but to constantly adjust our course.

Let me comment on why I'm talking about professional services firms rather than CPA firms. The demand for tax and management consulting services is growing at a faster rate than the demand for audit services, so these services are becoming more important as avenues for growth. As a matter of interest, I spent the past 20 years of my 29 working years primarily in international operations and consultation after starting in audit.

Increasingly, clients are looking to us to view their business issues from a business advisory perspective. To respond to this demand from the marketplace, we are expanding our vision of the business to include a broader range of financial, operational, and information management skills and services.

Competition for professional services has been intensifying and this will continue. Ten years ago, as CPA firms, we could not advertise or solicit business. Now, we compete in developing business relationships worldwide, and competing against a wide variety of professional services firms. These firms include our traditional Big Six competitors, and increasingly, non-traditional competitors like investment and commercial banks, law firms, and various consulting firms.

Globalization of Markets

Let's look at some other forces transforming the marketplace. We're experiencing the birth of a truly global business environment. Long-standing trade barriers are being eliminated, new markets are opening, and joint ventures are criss-crossing national boundaries. Globalization will be the watchword of the 1990s. The ability to attract and retain major accounts depends on the depth of your worldwide resources.

1992 – the U.S.-Canada Free Trade Agreement – emerging world markets, and cross-border offerings are rapidly establishing global free trade. Enormous business opportunities are emerging from these initiatives. Most recently, we have witnessed remarkable social and political events in the Soviet Union, East Germany, and Hungary which have profound implications. As a matter of interest, I feel professional services is one of the few areas the U.S. has a true competitive advantage and a lead on foreign competition.

In Continental Europe, a unified, deregulated market of 320 million people is well on its way to becoming a reality. Even before 1992, the transition to a fully integrated European market is creating increased activity. Companies are recognizing the need to move quickly and intelligently to position themselves to benefit from this enormous market. The need for strong, leading edge practices outside the U.S. *was a driving force in our merger.*

Speaking of competition, let's not neglect to mention the importance of Japan. The tremendous growth in Japan's stature and influence in the global business community is shown by statistics pertaining to the top 10 worldwide banks by size. Twenty years ago, there were six U.S. banks on the list, and none from Japan. Today, there are eight from Japan, and none from the U.S.

These market forces were an important consideration in our forming Ernst & Young. Our clients are demanding greater levels of service and industry expertise from their business advisors in every market as they move toward global operations. The merger gives us extensive professional service capabilities to meet and anticipate our clients' needs worldwide. Meeting the needs of clients, no matter where they do business, is a fundamental reason for mergers of professional services firms. Meeting those needs with a depth of service capability is essential. Mergers are driven by these objectives.

Globalization has led us to develop: a strong worldwide firm; industry and functional capabilities to help multinational corporations address financial, operational, and information management needs; a single worldwide audit approach; and the ability to coordinate audit teams no matter where located. Multinationals want outstanding resources in places like Nigeria, Korea, Thailand. The merger also allows us to accelerate our response to the opportunities provided in the worldwide market.

Competitive Position

While the opportunities are significant for professional services firms, so are the competitive threats. For professional services firms, market position is critical to being competitive. This is true for geographic, industry, and functional markets. Building position generally requires significant investment and time. Mergers are one way to quickly gain the critical mass needed in target markets to improve market position and needed to develop service capabilities that can be responsive to the most significant and complex client issues. The merger has given us greater geographic coverage in functional specializations by industry, allowing us to take advantage of more market opportunities by providing more services to clients.

Compatibility

In order for merged firms to take proper advantage of these opportunities, the merging firms must be compatible in international and domestic geographic markets, in industry markets, and in functional markets. The merging firms must also be compatible in goals, strategies, and values. Otherwise the merger may cause as many problems as it solves. Compatibility was a prime consideration in planning Ernst & Young.

Client Service

There are a number of other important reasons for mergers that are client-related. Clients increasingly seek help dealing with a variety of complex business issues, including:

- Industry-specific issues,
- Technology issues,
- Operations issues, and
- Finance issues.

We know that industry experience is the single most sought-after trait among clients looking for a firm like ours. And, clients also want quality service at reasonable fees. The critical mass created makes it easier to specialize, and it accelerates the ability to identify market needs and respond to opportunities.

In the case of Ernst & Young, our recent merger better positions us to help clients by deepening and broadening our functional and industry service capabilities. It allows us to better provide services when and where they are needed in technical specialties within targeted industry practices such as financial services and health care. The expanded services available are important to clients of all sizes, not just large multinationals, but mid-size companies and others as well.

Financial Implications

Another reason for mergers is that they help increase efficiency. The resulting firm is better positioned to use its resources more effectively as a result of greater economies of scale. Moreover, there are opportunities for rationalization in the administrative area, and for enhancing service. A larger base is available to support significant investments in the audit, tax, and consulting practices for future growth and profitability. Specifically:

- There can be increased investments in productivity, quality, research, education and training, marketing, and proprietary software.
- Management information systems can be combined and enhanced, which is the case with Ernst & Young.
- Offices in the same city can be merged, however, long term leases and the cost of negotiating new ones make this complex.

"Corporate Citizenship"

Merged firms also are generally in a better position to act as good corporate citizens by making greater contributions to the community. For example, we are the sponsor of the U.S. Olympic Job Opportunity Program in which we are helping 400 U.S. Olympic athletes obtain career-oriented employment.

Worldwide, we have been authorized by the Nobel Foundation to sponsor the Nobel Prize Services of programs, consisting of the Nobel Prize ceremonies telecast, and the Nobel video and curriculum library for high schools and colleges.

Human Resources

In the human resources area, media coverage of mergers tends to focus on people displacement, and rarely mentions the opportunities mergers present to the people involved. The expanded capabilities of a merged firm should be attractive in the marketplace.

The merger impacts people, management, processes, systems – and most people have some difficulty with change. On the other hand, it has allowed us to use a clean sheet of paper to design what is needed, going forward.

What, then, is the bottom line? Our merger has significantly strengthened our firm and the profession. We can now *invest in the people* and *technology* to keep up with the challenges of our changing business environment.

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I have been invited to this conference to present my views on the fact of the recent mergers among large accounting firms. These mergers present a number of interesting questions and issues. Certainly, they are complex and it is unlikely that their impact can be discernable until a significant period of time passes. In order to accomplish the goals of this paper, I have chosen to focus on the possible impact of the mergers on the quality of audits. In fact, my views are really in the nature of concerns that arise from firm size, whether the result of merger or growth from other sources. I will present these concerns along three lines of reasoning.

1. Too Much Help

One of the reasons that firms merge is to marshall more and better developmental resources. When national staffs are assembled for the purpose of research and development, naturally they undertake activities consistent with that purpose. In today's environment, that means developing more, and more sophisticated, computer-based audit decision aids. These tools should improve both the effectiveness and the efficiency with which audits are performed, and provide greater consistency across the firm's practice. However, they also may provide certain negative effects:

- First, sophisticated audit tools require training for proper use. There may be a risk that if the cost of that training is great, a firm will fail to provide it on a comprehensive and/or timely basis. This could result in improper implementation and misuse of the tools.
- Second, use of decision aids may cause auditors to become mechanistic in their approach to the audit. Their focus may fall on completing the questionnaire or getting the computer program to work rather than on accomplishing the audit objective. They may fail to understand the concepts and processes that underlie the tools, and this may result in failure to recognize aberrations to the situations the tools were designed for and how to deal with them.
- Finally, use of decision aids may preclude auditors from developing experience of the type required to make higher-level judgments. In other words, if the auditor's efforts are aimed at successful use of the decision aids, those efforts may supplant other types of experiences that are more instructive in nature.

2. Growth, Growth, Growth

Large firms seem to need to keep growing. I see at least two reasons for this. First, there appears to be an economically-based growth spiral in effect. Firms need to hire and provide incentives to top-notch people in order to stay competitive. This requires that new opportunities exist for those people.

Those opportunities can be created by acquiring new clients and engagements. In addition, as a firm grows, so do the number of its partners. In turn, as time passes, the number of retired partners increases significantly. A growing pool of current and future retired partners carries with it a significant pension funding obligation. In order to meet that obligation and at the same time adequately compensate working partners, the firm must maintain increasing profits over time, which requires growth.

In addition to the economic spiral, or perhaps because of it, there seems to be an attitude of competitiveness among members of large accounting firms that motivates growth. It might be expressed as a "grow or die" philosophy; or a belief that bigger firms are inherently superior to smaller firms, so growth is a means of becoming the best among the large firms.

I see several potentially negative effects from an over-orientation towards growth:

- First, it may cause pressure to free partner time to devote to practice development, which in turn results in delegation of engagement responsibilities to lower staff levels. This may reduce audit quality.
- Second, it may serve as a motivation to accept marginal clients. This could have several ramifications. For example, clients may be obtained that have dishonest management who could effectively deceive the auditor. Or, the client acceptance might be rationalized by understating the real risks associated with the client, thereby increasing the audit risk incurred.
- Growth may cause increased specialization. On the one hand, that could be beneficial to an audit practice, but on the other hand, it could go too far and result in a lack of auditors who can provide a broad perspective to managing audit engagements.
- It's possible that partners or managers who are not effective business developers will be pressured or culled out of the firm. These may, however, be persons who have strong technical skills. Over time, this could seriously deplete a firm's technical resources.
- There may be pressure on audit partners to "go beyond the audit" and be a "true financial advisor" to the client. This could cause the partner to lose his or her objectivity in conducting audits.

3. Unbalancing the Risk-Reward Relationship

The area of practice that has the greatest potential for growth is consulting. Not only is the market broader in terms of service opportunities, profit margins are greater than for audit services. Some firms follow a strategy of providing audit services for artificially low fees in order to create opportunities for higher-profit consulting work. As a firm expands in consulting, and audit is relatively stable, one could expect mounting economic pressures within the firm to allocate earnings in proportion to contribution, i.e., more earnings to consulting partners and less to audit partners.

At the same time, audit partners are subject to greater risk than consultants due to the nature of auditing and the related liability that exists, including criminal liability. Thus, the situation exists where the risk-reward relationship for partners in the audit practice of a firm can become severely out of balance. Better audit partners will respond to this by leaving the audit practice, which in turn will negatively effect audit quality.

4. Summary and Conclusion

The purpose of my remarks has been to indicate a series of concerns that I have about some potential negative effects on the quality of auditing that could arise from the extensive growth of large public accounting firms. In doing this, it is not my intention to suggest that mergers and growth should be disallowed. Rather, I am attempting to suggest that large firms must be sensitive to these problems and control them through effective management. This may be problematical, however, because of all of the urgencies affecting management during the period of a large merger as well as the fact that the problems I have cited are essentially behavioral in nature and difficult to deal with.